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The thing which is needed to secure healthy conditions is the most speedy and complete adaptation possible of the structure of production to the proportion between the demand for consumer's goods and the demand for producer's goods as determined by voluntary saving and spending. If the proportion as determined by the voluntary decisions by individuals is distorted by the creation of artificial demand, it must mean that part of available resources is again led into the wrong direction.

Friedrich A. Hayek, *Prices and Production*, London, 1931

NO CHANCE FOR A U.S. RECOVERY

The primary preoccupation in economics worldwide is the U.S. economy's recovery, presently hyping the markets. We note three different views. *First*, a cocksure bullish consensus; *second*, doubtful voices, among them the Federal Reserve, stressing the lack of conclusive evidence; and *third*, a few lonely voices, ours among them, who flatly repudiate the possibility of a full-scale, self-sustaining economic recovery in the United States. We see years of Japanese-style sluggish growth for America, if not worse.

Hope and hype are again triumphing over reality. The latest American Association of Individual Investors poll showed 71.4% bulls and a miniscule 8.6% bears. The gap between the two is the highest since August 1987, just weeks before the crash. Merrill Lynch surveys show institutional investors more fully invested than at any time in the past two years, and heavily overweight high tech.

The case of the bullish community rests crucially on the assumption that the U.S. economy is basically in excellent shape. Fed Chairman Alan Greenspan, and with him the large bullish community, have actually never seen anything seriously wrong with it.

In their view, its failure to return to normal economic growth is mainly due to a series of exogenous shocks inflicted one after the other on the economy: the stock market crash, the September 11 terrorist attack, the corporate governance scandals and the Iraq war. Rather, they consider it a sign of health that the economy has not weakened more in the face of this unusual sequence of shocks.

Yet compared to the extraordinary exuberance prevailing in the markets, the Fed has been remarkably hesitant in declaring the economy's impending recovery. In his testimony to Congress, Greenspan acknowledged that the *"economy is not yet showing convincing signs of a sustained pickup in growth."* In the same vein, Richmond Fed President Alfred Broaddus said a bit later in an interview, *"We still don't have a critical mass of hard evidence that the economy is accelerating,"* defining *"hard evidence"* as increases in employment, production and capital spending.

Now to our own opinion: After careful analysis both of recent economic data and also of basic micro- and macroeconomic conditions for the resumption of strong economic growth, we have come to two conclusions:

First, the U.S. economy neither improved nor accelerated in the second quarter. The reported GDP growth of 2.4% is grossly misleading. From the perspective of quality, it has distinctly deteriorated.

Second, as we shall explain in detail, the crucial macro- and microeconomic conditions for a self-sustaining and self-reinforcing economic recovery remain flatly missing. Necessary economic and financial adjustments of past economic and financial excesses implicitly involve pain. But pain is not accepted in the United States. In essence, policymakers are trying to cure past borrowing excesses by more of the same and new excesses.

A NOVEL RECESSION

Trying to assess the U.S. economy's prospects, the first thing to realize is that past cyclical experience offers no guidance to the present downturn because it has completely different causes and also a completely different pattern.

All past recessions had their main cause in monetary tightening. As soon as the Federal Reserve loosened its shackles, the economy promptly took off again, propelled by pent-up demand. For the first time in history, the U.S. economy went into recession against the backdrop of most rampant money and credit growth.

Manifestly, the forces depressing the economy this time are radically different from past experience. The typical, major imbalance in the postwar business cycles was in inventories. To correct it, retailers and manufacturers temporarily sold from stock, depressing production. Once the stocks were down to desired levels, production came into its right again. At the heart of the regular V-shaped business cycles was the inventory cycle.

In contrast, the present downturn has its brunt in the combination of a profit and capital-spending crisis. At the same time, there has accumulated an array of economic and financial dislocations that tend to depress the economy in many ways, such as extremely poor profits, badly ravaged balance sheets, a variety of asset bubbles in different stages of development, excessive leverage in the whole financial system and shrinking cash flow. There is nothing normal anymore in the U.S. economy and its financial system.

For the old economists, investment in tangible assets — factories, commercial buildings and machinery — was paramount in creating both economic growth and wealth. It creates demand, employment and income as the capital goods are produced. And with their installment, all these new buildings, plant and equipment create increased supply along with increasing employment and income with increased productivity.

The United States has always been a low-savings and low-investment economy. Putting it in reverse: a high-consumption economy. But all three went to unprecedented extremes over the past several years. They have been run down to atrociously low levels that are typical for underdeveloped countries.

To repeat: Investment in tangible assets is paramount in creating everything that is decisive in generating our wealth and raising our living standards. Given the low levels of saving and investment in the United States, American policymakers and economists in recent years have elevated productivity growth to the single most important achievement of an economy. But just by itself, productivity growth creates only unemployment. It is the normally associated capital spending that makes for the necessary, simultaneous demand and employment growth.

This simple recognition — gross lack of saving and capital formation — is really at the root of our controversial and highly critical view of the U.S. economy's sanity and vitality. True, its growth rate has been the highest among the industrial countries for years. But it has all the time been economic growth of the most miserable quality. The striking hallmarks of this extremely poor quality were collapsing savings, low rates of business fixed investment, a profit carnage that began at the height of the boom, exploding

consumer and business debts and an exploding trade deficit.

Today's economists have at their disposal information in quantity and speed as never before. But reading numerous reports, we have the impression that very few are making use of it. Particularly shocking in this respect were the immediate euphoric reports about the growth acceleration in the second quarter.

THE HORRIBLE SECOND QUARTER

For America's bullish community craving for some data that seem to confirm the U.S. economy's widely predicted recovery, better-than-expected figures for second-quarter gross domestic product growth were great news, provoking generally exalted comments. According to the revised data, the economy grew 3.1% at annual rate, as against the earlier consensus estimate of a 1.5% annualized growth rate.

Taking a closer look at the overall data for the quarter, the first huge stumbling block that we spotted was the fact that the GDP aggregate owed its better look entirely to a big jump in defense spending, having provided no less than 55.2% ($40.6 billion) of the reported GDP growth of $73.5 billion. During the first quarter, it had decreased by $6.5 billion.

Total government spending added 1.53 percentage points to the reported GDP growth rate of 3.1%. Just 1.57 percentage points came from the private sector. Ironically, this was little more than in the first quarter, when it had accounted for 1.32 percentage points of the reported GDP growth rate of 1.4%.

Manifestly, this burst in defense spending was by far the single most important fact about the economy's performance in the second quarter, and certainly a most negative one. Yet the Commerce Department and various media reports alluded to it only with the remark that defense spending had risen 44% at annual rate. Yet its central role in boosting GDP growth was treated with silence.

Why? Is it deliberate misinformation or simply slipshod work? In our view, it is, as usual, definitely the latter. The whole economic discussion today is fixated on the next economic data with one single question in mind: Is it better than expected? Careful, more detailed analysis with a longer-term perspective is completely missing. Obviously, most economists and journalists read no more than the brief summaries provided by agencies, like Bloomberg and Reuters, that only rehash the summaries preceding the official releases.

We have read enthusiastic assessments that defense spending will become the U.S. economy's new engine of growth. Happy memories of President Ronald Reagan's defense spending boom easily come to mind. However, there is a crucial difference between such spending then and recently. In the 1980s, it took place within a long-term rearmament plan, while its burst in the second quarter was mostly war-related one-off spending to be followed by a steep plunge.

Without exception, all reports conveyed the impression that capital investment was coming in strongly. The most exciting paragraph of the Commerce Department's first release about GDP growth in the quarter read, *"Real nonresidential fixed investment increased 6.9% in the second quarter, in contrast to a decrease of 4.4% in the first. Nonresidential structures increased 4.8%, in contrast to a decrease of 2.9%. Equipment and software increased 7.5%, in contrast to a decrease of 4.8%. Real residential fixed investment increased 6%, compared with an increase of 10.1%."*

From *The Wall Street Journal* we learned *"that consumer spending accelerated to its fastest pace since the fall; business investment grew at its fastest rate in three years and construction was stronger than thought."*

To be sure, those numbers, widely reported and quoted, suggested no less than a vigorous turnaround

in capital spending. On closer look, though, it was mainly the singular American habit to annualize many figures that accounted for the apparent strength of the numbers. Quarterly data are implicitly quadrupled. In other words, they are four times the reality that would be reported in other countries.

Stripped of annualization, business investment on structures increased in reality only 1.2%, rather than 4.8%, and on equipment and software by 1.875%, rather than by 7.5%. We are sure that these true, paltry numbers would have caused little more than a yawn in the markets. Only annualization made them remarkable.

Now, let us review the private sector. Here, too, figures have been highly deceptive.

Total government spending rose by $34.5 billion, contributing 47% to GDP growth of $73.5 billion. Within the private sector, consumption increased by $62.4 billion and business fixed investment by $22.4 billion. Scrutinizing the pattern of the latter, we spotted another big statistical deformity.

Particular attention found the strong numbers for business fixed investment. Its protracted weakness had been the missing link for a full-scale, self-sustaining recovery. But as already mentioned, stripped of annualization, there was in reality very little or nothing to boast about.

What's more, on closer look, one single component accounted for more than the overall increase in business fixed investment, and that was investment in computers. Measured in chained dollars, this investment component soared by $38.4 billion, or 12%, from $319.1 billion to $357.5 billion. This, clearly, looked like a new boom.

Again, though, a closer look has sobering effects. In its bulk, this boom-like increase in investment spending on computers never occurred. It overwhelmingly accrued from the furious use of the hedonic deflator that America's governmental statisticians use when measuring computer output and investment with the declared idea to capture quality improvements.

Measured in current dollars, this spending rose from $76.3 billion in the prior quarter to $82.6 billion, up a paltry $6.3 billion. By the way, this is far below previous peak levels. In chained dollars and with the help of hedonic pricing, however, this paltry increase translated into the big increase of $38.4 billion that went into real GDP growth. That is, fully $32.1 billion of the recorded increase in business fixed investment came from hedonic pricing of computers.

We have always questioned the economic sense of adjusting price indexes for quality improvements. One reason is that the consumer has no choice. He is forced to pay for them whether he wants them or not; a second reason is that quality improvements are simply inherent to permanent economic and technological progress. And a third reason is that endless quality improvements over time essentially end up with falling price indexes creating the false impression of deflation. In any case, when such an adjustment in the price indexes accounts for about 50% of GDP growth, this practice becomes grotesque.

Now, please consider the following. Aggregate U.S. real GDP in the second quarter grew by $73.1 billion. Of this total, $32.1 billion, or 44%, accrued from hedonic pricing of computer investment. In its absence, GDP would have increased a mere $26 billion, implying a growth rate of 0.27%, or 1.04% annualized. Even including the huge defense spending, this is hardly better than the growth rates in the rest of the world.

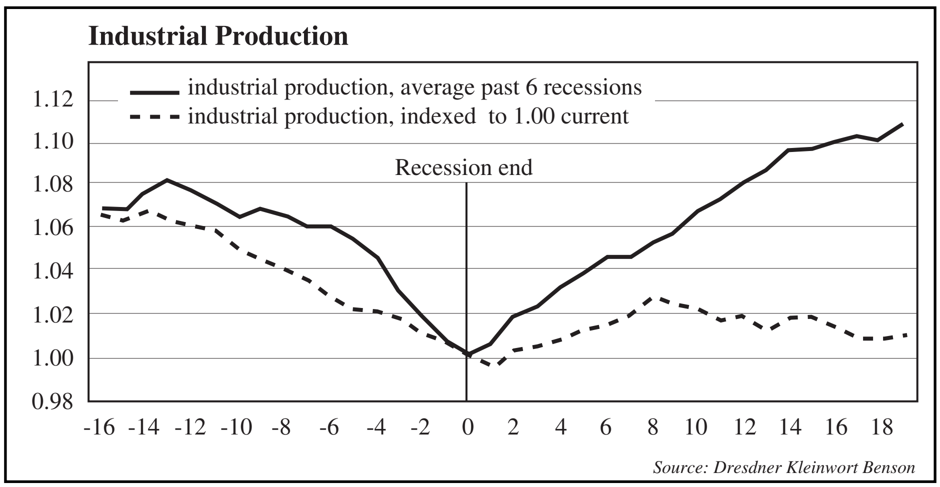
How to evaluate the pace and pattern of recent U.S. economic growth in light of these massive distortions? First of all, we flatly contradict the predominant view that the economy has effectively

strengthened during the second quarter. Taking away government spending and hedonic pricing of computers, there comes into view an economy that has definitely weakened further. In many ways, it has continued to worsen. It was all government and consumer spending with a tremendous, inherent leakage to foreign producers.

EMPLOYMENT DISASTER

The strongest and virtually compelling evidence of an economy that is far away from any recovery is the disastrous job numbers. There has been much talk that America had its slightest recession in the whole postwar period. That is measured in real GDP growth, being bolstered by many statistical tricks. Measured, however, by job losses, which certainly are the far more important gauge, it is already America's worst recession by far.

In June it was declared that the recession had ended in November 2001. Yet in the 20 months since, payroll employment has declined by a total of about 1 million jobs, or about 8%. In not one of the seven or eight postwar recoveries has there been any employment decline. Immediate strong job growth has been the regular characteristic of all business cycle recoveries. On average, payroll jobs increased 3.8% in the 20 months following the end of recession.



What's more, no letup in job losses is in sight. During the second quarter, widely hailed for its better-than-expected GDP growth, the household measure of employment slumped by 260,000. However, this figure concealed an even greater number of workers — 556,000 — who statistically quit the workforce because they have given up looking for nonexisting jobs.

The rapidly growing number of these people no longer count as unemployed. What the American job statistics really measure are not changes in unemployment, but changes in job seekers. Including the *frustrated* job seekers, the U.S. unemployment rate is hardly lower than in Europe. Certainly, it is rising much faster.

In addition, the Labor Department is employing month for month the same two practices that camouflage the horrible reality. In July, for example, it reported a decline in payrolls by 44,000, while job losses for June were revised upward from 30,000 to 72,000. For May, the retrospective upward revision was even from 17,000 to 70,000. As such upward revisions of job losses in the prior month have become a regular feature, this practice has the convenient effect of producing correspondingly lower new numbers every month. The same happens, at more moderate scale, with weekly reported claims.

There is still more spinning involved. The government adds every month some 30,000–50,000 imaginary workers to the job total. It is based on the assumption that in an economic recovery a lot of people start their own business. In normal recoveries, they have done so, indeed.

All it needs to activate this statistical job creation is a unilateral decision by the government that the economy is in recovery. Once a year, the statisticians reconcile their assumption with reality by a revision. When they did this in May of this year, 400,000 new jobs that had been reported earlier simply vanished. Such revisions, of course, take place outside the monthly reported job losses. Together, we presume, these statistical casuistries have reduced the reported job losses in the past two years by well over 100,000 per month.

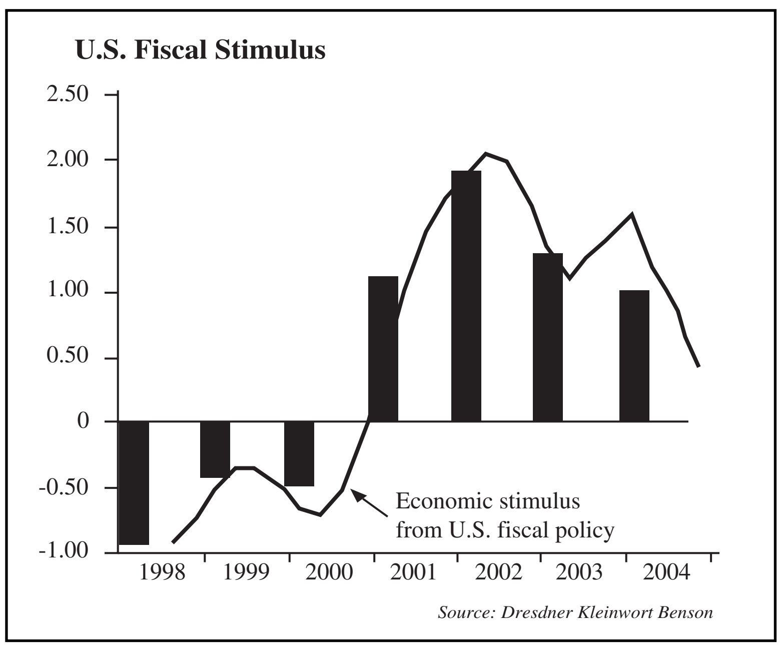
BLUNTED MONETARY AND FISCAL STIMULUS

It rather abruptly became the consensus view that in America the great recovery from protracted, sluggish growth is finally on its way. Record-low interest rates, runaway money and credit growth, new big tax cuts, record-high cash-outs by consumers through mortgage refinancing, increasing house and stock prices, and rising profits are cited as the compelling reasons for this optimism.

We are more than skeptical about the true impact of all these influences on the economy primarily for one reason: Most of them, if not all of them, have been at work for some time already, but with grossly disappointing overall effects on the whole economy, and now some of these influences are weakening or even reversing.

Think of the sharp rise in long-term interest rates that is most assuredly stopping the mortgage-refinancing bubble dead in its tracks. That, in our view, will not only abort any recovery but will also mean the economy's relapse into new recession.

As for fiscal policy, it clearly gave its biggest boost to the economy between the fourth quarter of 2000 and the second quarter of 2002. That is a period of six quarters during which the federal budget gyrated from a quarterly surplus of $306.1 billion to a deficit of $526 billion, both at annual rate. This year, the deficit is supposed to hit $455 billion. Most probably, it will come out much higher. But this follows a deficit in the last year of $257.5 billion. The fiscal stimulus is waning, not increasing.



In any case, actual, historical experience in the 1970–80s with large-scale government deficit spending has been anything but encouraging. It created more inflation than economic growth. Over time, rising deficits were rather recognized as impediments to economic growth. Japan's recent experience makes frightening reading. Since 1997, government debt has skyrocketed from 92% to 150% of GDP, rising every year by more than 10% of GDP. Yet nominal GDP keeps shrinking.

As to monetary policy, we have very much the same doubts about its efficacy in generating economic growth under current economic and financial conditions. It is the traditional American consensus view that monetary policy is omnipotent if properly handled. In this view, any recession, or worse, always has its decisive cause in the failure of the central bank to ease its reins fast enough. In this view whatever happened

in the economy during the prior boom is irrelevant.

This time, both monetary and fiscal policies in America have acted with unprecedented speed and vigor. To people's general surprise, the economy's rate of growth abruptly slumped during 2000 from 3.7% in the first half to 0.8% in the second. Starting on Jan. 3, 2001, the Fed slashed its short-term rate in unusually quick succession. Within just 12 months, its federal funds rate was down from 5.98 to 1.82.

Assessing the development, the first thing that struck us as most unusual was that this sudden, sharp economic downturn occurred against the backdrop of most rampant money and credit growth. Total nonfederal, nonfinancial credit grew by $1,144.3 billion in 2000, after $1,102.6 billion in the year before. This compared with nominal GDP growth during the year by $437.2 billion. The first important conclusion to draw therefore was that this sudden economic downturn had obviously nothing to do with money or credit tightness.

Ever since, nonfinancial credit growth has sharply accelerated. In the fourth quarter of 2002, it hit a record of $1,612.8 billion, at annual rate, followed in the first quarter of 2003 by $1,338.3 billion. This coincided with simultaneous nominal growth of $388.4 billion and real GDP growth of $224.4 billion, both also at annual rate. For each dollar added to real GDP, there were thus six dollars added to the indebtedness of the nonfinancial sector.

During the 1960–70s, by the way, it was on average about 1.5 dollars of additional debt for each dollar of additional GDP. Just extrapolate this escalating relationship between the use of debt and economic activity. And think of it: the GDP growth of today is tomorrow a thing of the past, while the debts incurred remain. Plainly, Greenspan's policy has collapsed into uncontrolled money and debt creation that has rapidly diminishing returns on economic activity.

The late economist Hyman P. Mynsky would call this a Ponzi economy where debt payments on outstanding and soaring indebtedness are no longer met out of current income but through new borrowing. Soaring unpaid interests become capitalized.

During the two-and-a-half years since end-2000, when the Fed started its vigorous easing, indebtedness of the domestic nonfinancial sector has surged by about $3.3 billion and that of the financial sector by another $2.3 billion, in total by about $5.6 billion. This credit deluge compares with simultaneous real GDP growth of $416.7 billion, averaging an annual rate of 1.8%. Of this total, $185.9 billion came from government spending and $100.3 billion from hedonic pricing of computers, representing together a stunning 69% of U.S. GDP growth during this period. In other words, more than two-thirds of it was rather phony growth. Yet it correspondingly boosted productivity growth.

PUSHING ON A STRING

Considering the vast discrepancy between runaway money and credit growth on the one hand and the poor GDP growth on the other, the Federal Reserve is manifestly "pushing on a string." It is a slogan from the 1930s, ascribed to John Maynard Keynes. Yet there is one enormous difference between the experience then and today. In the 1930s, the economic sluggishness went together with a drastic money and credit contraction. This time, the protracted economic sluggishness goes together with exploding indebtedness. We guess the latter, with its tremendous debt creation, is even worse in the long run.

In our view, the U.S. economy and the world economy are at their most critical juncture in the whole postwar period. Whether or not the U.S. economy's generally expected and predicted recovery will

effectively materialize will be the cardinal question for years to come. It is the third "second-half" U.S. economic recovery in just three years on which everyone is betting, except most CEOs. They are selling their stocks at record rates.

Considering that the second half of 2003 is already two months old, the recovery ought to be plainly evident. Comprehensive analysis and careful scrutiny of most recent economic data tell us that all this talk about the U.S. economy's big recovery lacks any serious substance.

Eager for the earliest possible recognition of impending economic fluctuations, American economists have displaced meticulous micro- and macroeconomic analysis in favor of surveys and a variety of collective statistical indexes — the Institute of Supply Management, consumer confidence, early indicators of the Conference Board, etc. — ranking for them as early indicators in comparison to the lagging official data.

Remarkably, it is so far only these statistical artifacts that are, though modestly, suggesting a U.S. economic recovery. These statistical artifacts were essentially constructed on the model of past business cycles. But the point to see is that present economic conditions have nothing in common with past experience. The hard data, like production, employment, capital investment, new orders, in contrast, continue to reveal a languishing economy.

Looking among the hard data for an early indicator, we focus in particular on new orders for durable goods. They are — together with housing — the GDP components that lead every cyclical recovery. All the more striking is the complete neglect of these numbers in the discussion about the U.S. recovery. One of the reasons for this neglect, we suspect, is that these hard data plainly contradict the recovery story.

NO RECOVERY IN THE HARD DATA

For July, the U.S. Census Bureau reported a $1.7 billion, or 1%, increase in new orders for manufactured goods. This virtually equaled the increase for motor vehicles. Year-over-year, total new orders are down slightly 0.1% and unfilled orders by 3.3%.

Another key component among the hard economic data is industrial production. Year-over-year, it is down 1.4%. With minor fluctuations, it has been flat for months. Capacity growth, by the way, has been just 1.1% for the last 12 months.

With these extremely poor "hard" economic data in mind, the whole discussion about a fledgling U.S. economic recovery appears to us outright ludicrous, lacking the slightest substance. The shocking thing to us is the general lack of serious investigation of the actual facts.

First of all, it might be useful to remember the strength and the pattern of the past seven or eight recoveries that the United States underwent in the postwar period. Ironically, the predicted growth rates for the supposedly incipient recovery are well below those that were achieved in past recoveries. Overall, growth of domestic demand during the first eight quarters of recoveries averaged a stellar 5.4% at annual rate. Percentage wise, residential construction (+13.2%) and investments on producer durables (+9.4%) had the highest rates of growth. Consumption grew a bit less than the average.

NO FOUNDATION FOR A RECOVERY

Finally, we want to make two crucial points about the alleged U.S. economic recovery: first of all, the increases in U.S. GDP growth since the end of the recession in the third quarter of 2001 in any case in no

way qualify as a recovery because they have lagged and continue to lag the rate of the economy's potential growth. That is, the economy's slack keeps growing.

This confronts us with the next query: the prospects for recovery in the long run. It is, of course, really a question consisting of two parts: *first*, what exactly has caused and keeps causing the U.S. economy's protracted sluggishness; and *second*, are these impediments on the mend or not?

As we have already repeatedly stressed, the U.S. economy's present malaise has manifestly nothing to do with tight money or credit. Measured by their expansion, they have never been looser than in the past years, and getting ever looser and looser. It is important to keep this in mind. It should suggest that monetary easing is therefore most probably not its cure.

It is the easy-going consensus view among American policymakers and economists that the economy owes its woes to various external shocks and mainly to an extraordinary capital spending bubble in the past boom years. Its evil legacy is seen in a large and broad capacity overhang that has robbed businesses of the pricing power that is needed to make profits. The resulting profit carnage, in turn, is depressing business investment.

But for the bullish consensus the cure for this disease is well on its way. As firms are maintaining a tight lid on new investment, while capital depreciations keep rising, net capital investment has slumped to a postwar low. According to the general assumption, a shrinking capacity overhang over time will restore the business sector's pricing power to the benefit of profits. Higher profits will, in turn, spark the investment recovery.

The first fact to see is that the excesses and the structural dislocations that have compounded in the U.S. economy during the past boom years are far greater and far more pervasive than the bullish consensus assumes and is promulgating.

Our own comprehensive analysis has, instead, identified four major maladjustments that are depressing U.S. economic growth. If not corrected, the U.S. economy will remain stuck in protracted sluggishness. Actually, we fear that these maladjustments have become far too big to be corrected without disastrous economic and financial consequences for the United States and the world.

These structural maladjustments afflicting the U.S. economy are, in brief:

(1) A chronic, vast excess of domestic spending over domestic output, as reflected in the huge and soaring trade deficit;

(2) A major shift in the domestic spending and output pattern towards consumption, as reflected in its soaring share of GDP;

(3) Recklessly devastated balance sheets;

(4) A financial system that is grossly outgrowing economic activity.

Tracing the U.S. economy's growth-impairing structural problems has to start with the recognition that since 1997 aggregate domestic spending went increasingly in excess of domestic output. The striking evidence of this general spending excess was always the soaring trade deficit. After hovering around $118 billion between 1994–96, it went on a steep upward spurt in 1997, exceeding lately $500 billion, or 5% of GDP.

But inherent to this growing spending excess was in addition a drastic change in the pattern of spending among consumption, capital investment, net imports and saving. Inspired by the prodigious wealth effects from the stock market bubble, the America consumer went on a borrowing and spending binge that in his

vehemence has no precedent in history.

Over the three bubble years from 1997 to 2000, outstanding consumer debt grew overall by $1,518.2 billion, or 27.3%, as against a gain in aggregate disposable income by $1,152 billion, or 19.3%. The ratio of new debt to new income skyrocketed to 131.8%. It was below 50% in the early 1980s and below 30% in the 1960s.

From a structural perspective, the decisive point about the U.S. economy's development during these years was that consumption took a rapidly rising share of GDP. Measured in current dollars, it shot up to 76.6% as a share of GDP growth, its highest share in the whole postwar period, comparing with a long-term average of 67%.

We stress this point because the bullish consensus keeps trumpeting that the boom of these years had its main propellant in an investment boom that created the big capacity overhang now depressing new investment. This predominant, false impression has arisen from the GDP figures showing a sharp rise of gross capital investment.

In general it was not realized that this investment figure was heavily inflated by two factors. The one was the famous hedonic pricing of computers, and the other one was a drastic shift in the composition of business fixed investment from longer-lived industrial equipment to very short-lived high-tech equipment. As a result, a growing proportion of gross investment each represents replacement of obsolescent capital stock, rather than a net increase.

To give an idea of the size of this influence: Between 1997–2002, consumption of capital, that is, depreciations, in the private sector soared from $831.8 billion to $1,184.5 billion, or 42%. This increase by $362.7 billion accounted during this period for 17% of nominal GDP growth. Hedonic pricing of computers turned a small decline in computer investment in current dollars into a big rise by $180 billion in real terms, accounting for 14% of real GDP growth during this period. As an aside, all this adds, of course, to the measured productivity growth.

Third on our list of major maladjustments and growth impediments in the U.S. economy are extremely strained balance sheets both of consumers and businesses. Sharply accelerating credit and debt growth is the hallmark of all booms. But the credit and debt excesses in the United States since 1997 have been unique in size and pattern.

During the five and a half years, the American consumer has increased his indebtedness by $3.3 billion, or 58%, while his income rose $2.15 billion. It has been another record in the economy. But since record-low interest rates have kept a lid on the debt service as a share of income, the consensus has so far refused to see a problem. However, debt growth is racing ever faster in relation to income growth. Lately, debt growth between $800–900 billion at annual rate is comparing with income growth around $300 billion.

It was, of course, not income growth but the housing price bubble and the associated mortgage refinancing bubble that have fueled the escalating consumer borrowing and spending binge. Since 1997, total housing values have soared from $8.8 trillion to about $14 trillion, the bulk of it coming from house price inflation.

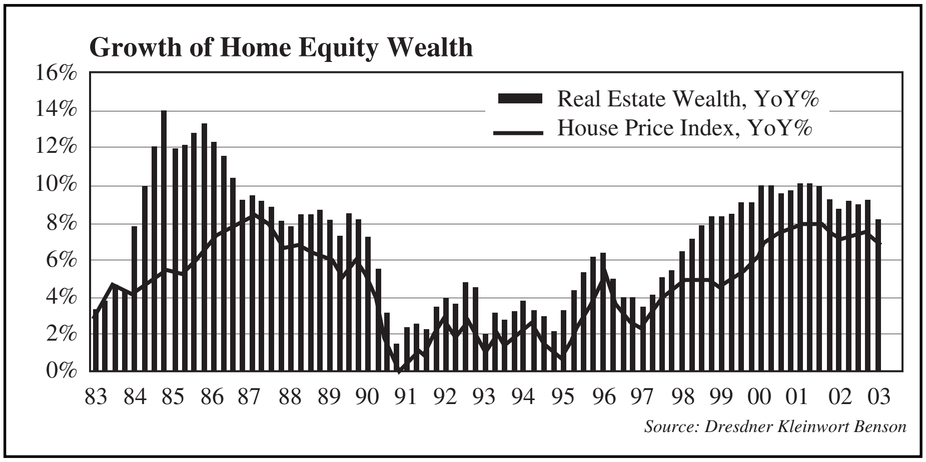
Is this a healthy sustainable development? With utter amazement, we took notice of a statement by Mr. Greenspan in a congressional testimony. He said, *"The prospects for a resumption of strong economic growth have been enhanced by steps taken in the private sector over the past couple of years to restructure and strengthen balance sheets. These changes, assisted by improved prices in asset markets, have left*

households and businesses better positioned than they were earlier to boost outlays as their wariness about the economic environment abates."

This is absolutely ludicrous. The consumer is piling up debt as never before, and Mr. Greenspan sees him strengthening his balance sheet. In days of yore, asset prices were viewed as a byproduct of underlying economic fundamentals. Now the shoe is on the other foot. Asset bubbles drive the economy, with Mr. Greenspan behind the wheel, and he seems to regard this as the new, healthy economic normality. Asset bubbles are not the problem; they are the solution.

This is not a central banker; this is a drug dealer addicting the people to limitless borrowing against asset price inflation that he promises to deliver.

The next big event in the U.S. economy, in our view, will not be the generally expected and predicted economic recovery, but the bursting of these new bubbles. It will shake the whole financial system.



There is one crucially important difference between a bursting stock market bubble and a bursting housing bubble that many people seem to overlook. In the case of the stock market bubble, there is one single loser — the stock owner. But when a housing bubble bursts, there are two losers — the borrower and the lender. Given the monstrous size of this bubble, it will put the whole financial system of the U.S. economy at risk.

American corporations, too, have worked hard to destroy their balance sheets during the past few years. Liabilities of nonfarm nonfinancial corporate businesses have skyrocketed by $3.6 trillion, or 55%, since 1997. But the disastrous key point is really for what this borrowing binge was used. Assets increased overall by 42%. Amongst the total, the stock of equipment and software rose by $579 billion, or 22%, and the stock of nonresidential structures (at historical costs) by $698 billion, or 36%. Financial assets, on the other hand, surged by 72.6%. Manifestly, there was a massive shift on the asset side towards financial assets at the expense of tangible assets.

But the expected profit miracle never happened. What materialized instead was America's worst profit performance in the whole postwar period. Regarding the profits that the corporations report as trash, we waited for the first official profit report in connection with the revised GDP release.

Here are the results: Total profits before tax were $591.5 billion in the second quarter, after $621.6 billion in the first quarter; nonfinancial profits were $359.2 billion, after $391.3 billion in the first quarter. As dividends rise while profits fall, the share of credit-financed dividends soared among nonfinancial firms from $62.2 billion to $102.8 billion.

As to the economy, the newly created asset and borrowing bubbles have through their demand creation been successful in preventing a longer and deeper recession in the United States, but it has to be realized

that this has been rendering the economy and its financial system more and more vulnerable. The cure is worse than the disease.

American policymakers and most economists have, apparently, yet to learn that rock-bottom interest rates are a double-edged sword in their effect on incomes. America has lots of eager borrowers. Nevertheless, private households own far more financial assets than they have debts, implying in the aggregate far higher interest receipts than interest expenses.

Currently, total indebtedness of around $8.8 billion compares with total holdings of financial assets around $30 trillion.

The rate cuts are generally cited as a great spur to the economy's recovery. The truth, though, is that a seeming bonanza for reckless borrowers has been unleashed at the expense America's savers, among them the pensioners and those on the cusp of their retirement. They now find that their savings are yielding 60–70% less than a few years ago.

The other victim of this policy is, of course, the younger generation in their role as first-time homebuyers. In their case, the beneficial effects of very low interest rates are largely offset by the escalation of house prices, requiring correspondingly higher borrowing.

CONCLUSIONS

The acceleration of the U.S. economic growth in the second quarter was more statistical semblance than economic reality. Defense spending and hedonic pricing of computers made all the difference in the first quarter.

The little strength in the private sector derived completely from bubble-driven consumer spending. But that bubble has been pricked by the sharp rise in long-term interest rates. Mortgage refinancing activity is dropping sharply.

Most importantly, America's economic and financial fundamentals are deteriorating across the board: profits, savings, debt levels and the trade deficit.

Speculation that the U.S. economy will recover versus a weakening euro economy has boosted the dollar. On closer look, it has not recovered at all. In reality, growth and currency fundamentals are deteriorating. For the first time since the end of 1998, long-term capital inflows are lagging the current-account deficit. In the case of the eurozone, both the current and capital account are in surplus.

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Dr. Kurt Richebächer, Editor
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